No. 14349.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

GEORGE R. CARR,

Appellant,

vs.

BEVERLY HILLS CORPORATION, a corporation; JOHN P. LOMBARD, MAYNARD BRANDSMA, FRANCIS E. BROWNE, ROBERT W. LANGLEY, HARRY F. DIETRICH, and ROSS J. FERRAR,

Appellees.

On Appeal From the United States District Court for the Southern District of California, Central Division.

BRIEF OF APPELLANT.

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BRIEF OF APPELLANT.

I.

PRELIMINARY STATEMENT.

This is an appeal by the plaintiff from a judgment of the United States District Court for the Southern District of California, Central Division, dismissing the complaint in a stockholders derivative action "* * * for lack of jurisdiction of this court over the subject matter * * *" [R. 272].

The plaintiff-appellant is a shareholder of the defendant-appellee, Beverly Hills Corporation [R. 3, 265], of which the individual defendants-appellees are, or have been, officers and directors [R. 4-5, 266], and the action is based upon a claim that the individual appellees abused their fiduciary position in various transactions which are set out in six counts of the complaint [R. 2-26], all of which must be taken as alleged upon a motion to dismiss.

II.
JURISDICTIONAL STATEMENT.

THE STATUTORY PROVISIONS.

The original jurisdiction of the United States District Court was invoked upon the ground that "The amount in controversy exceeds, exclusive of interest and costs, the sum of three thousand dollars ($3,000.00)" [R. 3] and is between citizens of different states [R. 2-3]. The District Court had jurisdiction under Title 28, U. S. Code, Section 1332, which provides in part:

> **"Diversity of Citizenship; amount in controversy.**
>
> (a) The district courts shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum or value of $3,000 exclusive of interest and costs, and is between:
>
> (1) Citizens of different States;"

This court has jurisdiction of this appeal under Title 28, U. S. Code, Section 1291, which provides in part:

> **"Final decisions of district courts.**
>
> The courts of appeals shall have jurisdiction of appeals from all final decisions of the district courts of the United States, * * * except where a direct review may be had in the Supreme Court."

And under Title 28, U. S. Code, Section 1294, which provides in part:

> **"Circuits in which decisions reviewable.**
>
> Appeals from reviewable decisions of the district * * * courts shall be taken to the courts of appeals as follows:
>
> (1) From a district court of the United States to the court of appeals for the circuit embracing the district;"

THE FACTS AS PERTAINING TO JURISDICTION.

The matter in controversy exceeds the sum or value of $3,000 exclusive of interest and costs [R. 3, 25, 267].

At all times mentioned herein appellant, George R. Carr, has been, and he now is, a citizen of Illinois and a resident of Chicago, Illinois [R. 2, 261, 265]; appellee Beverly Hills Corporation (hereinafter for brevity sometimes called "the corporation" or "appellee corporation") has been and now is a corporation organized under the laws of California and a citizen of California [R. 2, 265]; and appellees John P. Lordan, Maynard Brandsma, Francis E. Browne, Robert W. Langley, Harry F. Dietrich, and Ross J. Ferrar (hereinafter for brievity called "individual appellees") have been, and they now are, citizens of California [R. 3, 265].

III.

STATEMENT OF THE CASE.

Appellee Beverly Hills Corporation was organized in early 1949 for the purpose of acquiring a parcel of real estate in Beverly Hills, California, and constructing on a part of that real estate a modern, fully-equipped, building, designed to house an integrated medical clinic, and of leasing a portion of that building to a partnership of doctors for use as a medical clinic [R. 5-6, 223]; the corporation also planned to construct, equip, and operate for profit, within said building, an X-ray laboratory, a clinical laboratory, and a pharmacy and soda fountain, to construct a paved parking lot on the unoccupied portion of its real estate, adjoining the building, and to operate that parking lot for profit [R. 6-7, 33, 145, 148, 173-174, 179-181, 203, 223-224, 228, 230]. The income of the

corporation would thus be made up of the rent to be received from the lease of the clinic portion of the building and the profits to be realized from the operation of the other named facilities [R. 148-150, 155, 173, 180-181, 223-224].

Pursuant to said plan the corporation was organized and, on February 28, 1949, appellees Lordan, Brandsma, Browne, Langley, and Dietrich were elected directors of the corporation, they constituted the entire board of directors [R. 4, 90, 94, 101, 110, 114]; appellee Lordan was elected president of the corporation on the same date, and still holds that office [R. 4, 114]; appellee Brandsma was elected secretary-treasurer of the corporation on the same date and held that office until November 17, 1950, when he was elected vice-president [R. 4, 90]. Appellee Ferrar became general business manager of the corporation on September 15, 1950, and still holds that office [R. 4, 105], he became treasurer of the corporation on November 17, 1950, and became secretary of the corporation on or about November 12, 1952, and still holds those offices [R. 4-5, 105].

At all times since October 10, 1950, all of the individual appellees have been, and they now are, members of the Executive Committee of the corporation; they comprise the entire Executive Committee [R. 5].

During the holiday season of 1949-1950, and in April, 1950 [R. 145, 203, 225-226], appellant learned of the proposed corporation and its plans and purposes from appellees Lordan and Brandsma and from his son-in-law, Dr. Omar Fareed [R. 145, 203-204, 225-226, 260-261] and, wishing to help provide for the Los Angeles area an outstanding medical clinic in which his son-in-law could participate [R. 260-261] he, in about April, 1950, pur-

chased 400 shares of the common stock of the corporation and loaned $20,000 in cash to the corporation [R. 3, 146, 204, 261]. This was the first cash the corporation had received and it gave the corporation some standing with the bank [R. 261].

Thereafter, during 1950 and 1951, the corporation acquired by purchase ten (10) lots, constituting a single parcel of ground in Beverly Hills, California, for a consideration of about $300,000, and constructed thereon a medical clinic building which occupied about three (3) lots [R. 6]; in 1951 it acquired by lease from Martha Lordan, wife of appellee John Lordan, an additional adjoining lot, hereinafter referred to as "lot 761" [R. 6, 27], and in 1952 purchased said lot 761 for $35,000 [R. 6]. The corporation also graded, paved, and equipped, as a parking lot, the unoccupied portion of its real estate, consisting of about eight (8) lots and including lot 761 [R. 6].

During 1951 the corporation completed the construction and equipping of its building, including a clinical laboratory, an X-ray laboratory, and a pharmacy and soda fountain, and leased the greater portion of the building, other than the above facilities, for use as a medical clinic, to a partnership of doctors doing business under the style "The Beverly Hills Clinic" [R. 6-7, 155]. The building was completed and The Beverly Hills Clinic commenced its operations on or about September 1, 1951 [R. 155, 177-178, 199, 200, 227].

The Beverly Hills Clinic (hereinafter for brevity sometimes called "The Clinic"), lessee of most of the corporation's building, was a co-partnership of doctors and of one registered pharmacist, appellee Ferrar [R. 5, 105, 224];

all of the individual appellees were members and general partners of, and financially interested in, The Clinic [R. 5, 90, 94, 101, 105, 110, 114]; neither appellant nor appellee corporation was a member or general partner in, or financially interested in, The Clinic [R. 5].

The partners in The Beverly Hills Clinic, including appellee Ferrar, own and hold 91% of the outstanding stock of the corporation; the six individual appellees, alone, own and hold 42.1% of said stock [R. 60].

During 1951 and 1952 the individual appellees, as officers and directors of the corporation, caused the parking lot, the X-ray laboratory, and the clinical laboratory to be diverted, as profit-making facilities, from the corporation to The Clinic, and thereby to themselves as members and general partners of The Clinic [R. 9-10, 16-17, 19, 20, 148-150, 173-174].

In May, 1952, while the corporation, under the terms of its lease from appellee Lordan, held a first right of refusal to purchase lot 761 [R. 28], the individual appellees failed and refused to assert said right and permitted appellee John P. Lordan and his wife to sell said lot for $18,500 [R. 10, 17-18, 164-167] and paid $500 of the corporation's funds to the new owners of lot 761 for an option to purchase said lot for $35,000 [R. 30-31], and several days later did in fact purchase said lot 761 for the corporation for $35,000 on or about May 27, 1952, from the vendees of John and Martha Lordan [R. 10, 17-18, 66-67, 117-118].

In 1951 the individual appellees fraudulently and wrongfully caused and permitted the pharmacy within its building to be diverted, as a profit-making facility, from the corporation and to be placed under lease to appellee Ferrar

(with a remainder to appellee Lordan) [R. 39-41], who agreed to operate it as an accommodation to, and for the use and benefit of, the corporation [R. 21-24, 149, 169-172]. Since about September 1, 1951, appellee Ferrar has been in possession of said pharmacy and has denied his trust and asserts that the profits from said pharmacy are his own [R. 24, 107-108].

After the corporation had been stripped of all of its profit-making facilities, as described above, the end result was that not only had it lost its expected profits but all of its income was derived from rent [R. 10-11, 148-150], it became a personal holding company within the meaning of the Internal Revenue Code and subject to taxation as such [R. 11, 148-150], the corporate purposes were destroyed, and the majority stockholders voted to wind up and dissolve the corporation [R. 11, 128].

In November, 1952, appellant, in Chicago, Illinois, received a telephone call from appellee Lordan in Los Angeles, California, telling appellant of the state of the corporation's affairs [R. 145, 236, 261]. Appellee Lordan then sent appellant a letter dated November 13, 1952, confirming said telephone conversation [R. 146, 148-153, 236-237]. Said telephone conversation and letter were the first information appellant had received of the manner in which the corporation had been stripped of its income-producing facilities [R. 146, 261] and he immediately instituted an investigation into the manner in which the affairs of the corporation were being handled [R. 147].

In early December, 1952, appellant's attorneys commenced an investigation into the manner in which the corporation's affairs had been managed in respect of the foregoing transactions [R. 9, 12, 125]. At about that time appellant's attorneys were informed by appellee Lor-

dan that the Los Angeles law firm of Gibson, Dunn & Crutcher had been retained as legal counsel for the corporation [R. 12, 125, 135].

Thereafter, during December, 1952, and January, February, and March, 1953, appellant's attorneys made many requests and repeated efforts to inspect the books and records of appellee corporation [R. 154] and to investigate the above transactions, but they were permitted to make only a limited inspection [R. 9, 11-16]. In mid-March, 1953, the attorneys for appellee corporation learned that appellant had prepared and was about to file a derivative action against the appellees [R. 15, 133]; thereafter, on or about March 24, 1953, the attorneys for appellee corporation instigated proceedings [R. 134] to have appellees Brandsma, Browne, Langley, and Dietrich resign as directors of the corporation and to choose and elect their own successors. This was done [R. 15-16, 134, 136]. Appellee Lordan remained a director and president of the corporation [R. 114]; appellee Ferrar remained as secretary-treasurer and general business manager of the corporation [R. 105]. All of the individual appellees continued as members of the executive committee of the corporation [R. 5].

Having been unsuccessful in his efforts to obtain relief through the corporation [R. 9, 11-16] appellant, on April 30, 1953, filed his derivative action in the District Court [R. 2-45]. The law firm of Gibson, Dunn & Crutcher, from which appellant's attorneys had been trying to secure vital information of the corporation's affairs for nearly four months, continued to represent appellee corporation until on or about May 4, 1953 [R. 142]; at all times herein mentioned they have represented, and do now represent, the individual appellees. On or about

May 4, 1953, appellee corporation retained its present counsel, the law firm of Latham & Watkins [R. 142].

Appellee corporation and the individual appellees, on July 22, 1953, filed their separate motions (1) to dismiss for failure to state a claim upon which relief can be granted [R. 46, 88] or (2) in the alternative, for a security bond pursuant to Section 834(b) of the California Corporations Code [R. 46, 88]. The individual appellees also moved to strike the complaint as sham, false, vexatious, and frivolous [R. 88]. The question of jurisdiction over the subject matter, based upon diversity of citizenship, was never raised by the parties. Said motions having been argued and submitted for decision the District Court, on December 10, 1953, made its order dismissing said motions on the ground that it probably lacked jurisdiction over the subject matter of the action and hence lacked jurisdiction to entertain the motions [R. 253].

Thereafter, on December 23, 1953, appellee corporation and the individual appellees filed their separate motions (1) to dismiss the complaint for lack of jurisdiction over the subject matter of the action and (2) in the alternative, renewing their previous motions [R. 254, 257]. Said motions were argued and submitted to the court on January 11, 1954, and the court then announced its decision that the motions to dismiss for lack of jurisdiction over the subject matter were granted, and on January 27, 1954, made and filed its Findings of Fact and Conclusions of Law [R. 264] and Judgment [R. 271].

Appellant filed his Notice of Appeal on February 25, 1954 [R. 274].

IV.

SPECIFICATION OF ERRORS.

1. **The District Court Erred in Holding That, for the Purpose of Determining Whether Diversity of Citizenship Exists in the Within Action, the Defendant Corporation Must Be Realigned With the Plaintiff as a Plaintiff.**

This holding was erroneous because in testing diversity of citizenship the parties must be arranged on different sides of the matter in dispute *according to the facts.* In stockholder's derivative actions the stockholder's corporation is aligned with the defendant when the corporation is under control antagonistic to the stockholder and opposed to the object sought by him.

2. **The District Court Erred in Holding That the Defendant Corporation Has Not Been Under the Domination of the Individual Defendants, or Any of Them, or Under the Control of Any Person or Persons Who Have Been Antagonistic or Hostile to the Financial Interests of the Corporation at Any Time Since at Least as Early as March 25, 1953.**

This holding was erroneous since at all times pertinent to this case the corporation has been in the hands of the individual defendants, or of the persons selected by the individual defendants for the purpose of opposing the plaintiff's claims and, at the time of commencement of this action, was represented by counsel for the individual defendants. The individual defendants are also the dominant stockholders of the corporation.

3. The District Court Erred in Holding That the Corporation Was Not at the Time of the Commencement of the Within Action, and Is Not Now, Incapacitated From Bringing or Maintaining Suit Upon the Causes of Action Set Forth in Plaintiff's Complaint Herein and From Protecting Its Own Financial Interests.

A corporation can act only through its board of directors; therefore, when the board of directors refuses to enforce rights of the corporation, that corporation is, as a practical matter, incapacitated from acting in respect of such rights.

4. The District Court Erred in Holding That the Within Action Is Not One Between Citizens of Different States and That the Requisite Diversity of Citizenship Between the Plaintiff on the One Hand, and the Defendants on the Other, Did Not Exist at the Time of the Commencement of the Within Action and Does Not Now Exist and That It Did Not Then and Does Not Now Have Jurisdiction Over the Subject Matter.

This finding is erroneous since in this case the defendant corporation, when aligned *according to the facts,* must be aligned as a party defendant; when that is done there is complete diversity of citizenship between the plaintiff, a citizen of Illinois, and the defendants, consisting of a California corporation and individual defendants who are citizens of California. When the other jurisdictional requirements are present, as is true in this case, the District Court has jurisdiction over the subject matter.

5. The District Court Erred in Dismissing the Within Action for Lack of Jurisdiction Over the Subject Matter.

This conclusion and judgment is erroneous since the facts of the case as pleaded and established show that there was complete diversity of citizenship between the parties and all other jurisdictional facts appeared and, therefore, the court had jurisdiction over the subject matter.

V.

SUMMARY OF ARGUMENT.

The federal courts possess only such jurisdiction as is conferred upon them by the constitution and the laws of the United States. It is, therefore, incumbent upon the federal courts to examine their jurisdiction at the threshold of each case. In doing so the jurisdiction of the court must be determined with reference to the attitude of the case at the time of the filing of the action, and if jurisdiction exists at that time it cannot be ousted by subsequent events.

In examining federal jurisdiction which is invoked upon the basis of diversity of citizenship, the court is not bound by the arrangement in which the pleader has placed the parties, but will look beyond the pleadings and arrange the parties *according to the facts.*

In a stockholder's derivative action, such as instant case, the rule is that even though the cause of action asserted by the plaintiff will, if successful, inure to the benefit of the corporation, and the corporation is a real party in interest and an indispensible party, the corporation is, for purposes of testing diversity of citizenship,

aligned with the defendants whenever the officers or persons controlling the corporation are opposed to the object sought by the complaining stockholder and under a control antagonistic to him and detrimental to his rights. This has always been the rule in cases in which, as here, the management of the corporation has taken a position adversary to the plaintiff in the actual litigation of the case. The rule is not limited to those cases in which the individual defendants, the wrongdoers, constitute the management of the corporation, but it is also applied in those cases in which there is no indication that the refusal by the corporate management to sue results from fraudulent or other improper motives.

In those cases which may be characterized as "collusive" suits, or where there is a want of equity in the plaintiff, the action will, of course, be dismissed. Such facts are not found in instant case.

At the time of the commencement of the within action the corporation was dominated and controlled by the individual defendants and other persons who were antagonistic to the plaintiff and the objects sought by him.

A corporation can act only through its board of directors; therefore, when the board of directors refuses to enforce rights of the corporation, that corporation is, as a practical matter, incapacitated from acting in respect to such rights.

In the instant case, when the corporation is aligned *according to the facts* of its position in the controversy it must be aligned as a defendant. So aligned, there is complete diversity of citizenship, the other jurisdictional requirements are present, the court had jurisdiction over the subject matter, and the court erred in dismissing the action for lack of jurisdiction over the subject matter.

VI.

ARGUMENT.

A. Introduction.

This appeal seeks to reverse the decision of the District Court dismissing the complaint in a stockholder's derivative action for lack of jurisdiction over the subject matter. The District Court based its decision and judgment upon findings that, although complete diversity appeared from the face of the complaint [R. 2-3, 268], for the purpose of testing whether diversity in fact existed the defendant corporation, as a real party in interest, must be realigned with the plaintiff [R. 268]; after being so realigned the requisite diversity of citizenship between the plaintiffs and defendants did not exist and the court lacked jurisdiction over the subject matter and for that reason dismissed the complaint [R. 269]. The real question in this appeal is, therefore, "Did the District Court err in dismissing the complaint for lack of diversity of citizenship, and therefore lack of jurisdiction?"

As a preliminary matter it is pointed out that the decision of the District Court was in no way based upon an alleged failure of the plaintiff to comply with the requirements of Rule 23(b), Federal Rules of Civil Procedure. The verified complaint alleged, and the court found, that the plaintiff was a shareholder in the corporation at the times of the transactions complained of [R. 3, 265], that the action was not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction [R. 3, 267], and that *it would have been futile for the plaintiff to make further demands upon the corporation for relief* [R. 266] *in view of his previous efforts as alleged with particularity in the complaint* [R. 9, 11-16].

B. The District Court Erred in Holding That for the Purpose of Determining Whether Diversity of Citizenship Exists the Defendant Corporation Must Be Realigned With the Plaintiff.

Since the federal courts possess only such jurisdiction as has been conferred upon them by the Congress, within the limits prescribed by the United States Constitution (Art. III, Sec. 2), and the lack of federal jurisdiction cannot be waived or overcome by the agreement of the parties, it is incumbent upon the courts to examine their jurisdiction at the threshold of each case. (*Smith v. Sperling* (S. D. Calif., 1953), 117 Fed. Supp. 781, 787.)

In the words of Mr. Chief Justice Marshall:

> "It is most true that this court will not take jurisdiction if it should not; but it is equally true that it must take jurisdiction if it should. The judiciary cannot, as the legislature may, avoid a measure because it approaches the confines of the Constitution. We cannot pass it by because it is doubtful. With whatever doubts, with whatever difficulties, a case may be attended, we must decide it, if it be brought before us. We have no more right to decline the exercise of jurisdiction which is given, than to usurp that which is not given."
>
> *Cohens v. Virginia* (1821), 6 Wheat. 264, 404, 5 L. Ed. 257, 291.

The jurisdiction of the court must be determined with reference to the attitude of the case at the date of the filing of the bill; if jurisdiction exists at the time when the action is brought, it cannot be ousted by subsequent events. (*City of Chicago v. Mills* (1907), 204 U. S. 321, 328, 27 S. Ct. 286, 51 L. Ed. 504: *Grant County Deposit Bank v. McCampbell* (6th Cir., 1952), 194 F. 2d 469, 31 A. L. R. 2d 909, 916.) Thus where diversity juris-

diction exists at the commencement of an action a subsequent change of citizenship of one of the parties does not oust it, and likewise the citizenship of a subsequent intervening plaintiff is immaterial. (*City of Chicago v. Mills* (1907), 204 U. S. 321, 328 (*supra*); *Wichita R. R. & Light Co. v. Public Utilities Comm.* (1922), 260 U. S. 48, 53-54, 43 S. Ct. 51, 67 L. Ed. 124; *Jeffcott v. Donovan* (9th Cir., 1943), 135 F. 2d 213; *Smith v. Sperling* (S. D. Cal., 1953), 117 Fed. Supp. 781, 788; *Weinstock v. Kallett* (S. D. N. Y., 1951), 11 F. R. D. 270, 272.) Where federal jurisdiction is invoked on the basis of diversity of citizenship, however, the court will not be bound by the arrangement in which the pleader has placed the parties but it will "look beyond the pleadings and arrange the parties according to their sides in the dispute." (*Dawson v. Columbia etc. Trust Co.* (1905), 197 U. S. 178, 180, 49 L. Ed. 713.)

In a stockholder's derivative action the stockholder is asserting a cause of action belonging to his corporation and the courts have uniformly held that in such cases his corporation is not only a real party in interest but is also an indispensable party and the citizenship of the corporation must be considered in aligning the parties for the purpose of testing jurisdiction. (*Davenport v. Dows* (1873), 18 Wall. 626, 21 L. Ed. 938; *Groel v. United Electric Co.* (C. C. N. J., 1904), 132 Fed. 252, 254; *Dawson v. Columbia etc. Trust* (1905), 197 U. S. 178, 49 L. Ed. 713; *Venner v. Gt. Northern Ry.* (1908), 209 U. S. 24, 31-32; *Koster v. (American) Lumbermen's Mutual Cas. Co.* (1947), 330 U. S. 518, 67 S. Ct. 828, 91 L. Ed. 1067.) Since the cause of action asserted in a stockholder's derivative action is that of the corporation it would appear that the corporation should be aligned as

a party plaintiff for the purposes of testing jurisdiction. That is not the case, however, when the corporation has taken a position relative to the dispute which is hostile and antagonistic to that of the plaintiff-stockholder, it is then aligned as a defendant.

(1) The Alignment of Parties in Stockholder's Derivative Actions.

(a) GENERALLY.

For the purposes of determining jurisdiction based upon diversity of citizenship the courts have long been guided by the rule of Mr. Chief Justice Waite in the *Removal Cases* (1879), 100 U. S. 457, 469, 25 L. Ed. 593, 598:

> "For the purposes of a removal the matter in dispute may be ascertained, and the parties to the suit arranged on opposite sides of that dispute. If in such arrangement it appears that those on one side are all citizens of different states from those on the other, the suit may be removed. Under the old law the pleadings only were looked at, and the rights of the parties in respect to a removal were determined solely according to the positions they occupied as plaintiffs or defendants in the suit. * * * Under the new law the mere form of the pleadings may be put aside, and the parties placed on different sides of the matter in dispute *according to the facts.*" (Emphasis added.)

Twenty-five years later the rule of the *Removal Cases* was discussed, and the decisions of the intervening years were reviewed in the oft-cited opinion in *Groel v. United Electric Co.* (C. C. N. J., 1904), 132 Fed. 252. In that case the plaintiff, a citizen of New Jersey, brought a stockholder's action against a New Jersey corporation in which

he was a stockholder, and against a Pennsylvania corporation, in the Court of Chancery of New Jersey. The Pennsylvania corporation had the case removed to the federal court on the theory that since the plaintiff was urging the New Jersey's corporation's cause of action that company could not be aligned as a defendant but must either be deemed a nominal party or be aligned with the plaintiff. The cause was heard on a motion to remand, and the court, after reviewing many decisions following the *Removal Cases,* said (p. 263):

> "This contention has seemed to necessitate the foregoing review of the authorities. The rule deduced from them is that, in a suit in equity instituted by a stockholder in his own name, but upon a right of action existing in his corporation, the stockholder's corporation will be aligned with the defendants whenever the officers or persons controlling the corporation are shown to be opposed to the object sought by the complaining stockholder, and that, when such opposition does not appear, the stockholder's corporation will be aligned with the complainant in the suit." (132 Fed. at 263-264.)

In the *Groel* case the court held that the stockholder's corporation must remain where the pleader placed it, as a defendant, which in that case destroyed citizenship and ousted federal jurisdiction.

The decision in the *Groel* case has been cited with approval by the Supreme Court in *Venner v. Gt. Northern Ry. Co.* (1908), 209 U. S. 24, 28 S. Ct. 328, 52 L. Ed. 666; and *Hamer v. New York Railways* (1917), 244 U. S. 266, 37 S. Ct. 511, 61 L. Ed. 1125; and in various decisions of the Courts of Appeals, including *Lavin v.*

Lavin (2nd Cir., 1950), 182 F. 2d 870, 18 A. L. R. 2d 1017, wherein Chief Judge Hand said:

> "We need not deal at length with the plaintiff's suggestion that it is only when the jurisdiction of the federal courts will be sustained that in such actions the corporation may not be aligned as a plaintiff. True, so far as we have found that has been the case in all decisions of the Supreme Court, but it was not true in Groel v. United Electric Company, C. C. N. J., 132 F. 252, or in Kelly v. Mississippi River Coaling Company, C. C., 175 F. 482, which the Supreme Court cited with apparent approval in Hamer v. New York Railways, 244 U. S. 266, 37 S. Ct. 511, 61 L. ed. 1125. It may indeed be doubted whether as an original question the Supreme Court would not today align the corporation as a party plaintiff in all cases; nevertheless it has shown no disposition to change the rule in Doctor v. Harrington, 196 U. S. 579, 25 S. Ct. 355, 49 L. ed. 606, but has recognized its continued authority."

See also:

Schmidt v. Esquire, Inc. (7th Cir., 1954), 210 F. 2d 908.

The Supreme Court followed the same rule in the leading case of *Doctor v. Harrington* (1905), 196 U. S. 579, 25 S. Ct. 355, 49 L. Ed. 606. In that case the plaintiff-stockholders were citizens of New Jersey and brought a derivative action against the corporation defendant, in which they were stockholders, a New York citizen, and against individual defendants who were citizens of New York. In holding that the federal courts had cognizance of such an action the court said:

> "The ninety-fourth rule in equity contemplates that there may be, and provides for, a suit brought

by a stockholder in a corporation, founded on rights which may properly be asserted by the corporation. And the decisions of this court establish that such a suit, when between citizens of different states, involves a controversy cognizable in a circuit court of the United States. The ultimate interest of the corporation made defendant may be the same as that of the stockholder made plaintiff; but the corporation may be under a control antagonistic *to him,* and made to act in a way detrimental to *his* rights. In other words, *his* interests, and the interests of the corporation may be made subservient to some illegal purpose. If a controversy hence arise, and the other conditions of jurisdiction exist, it can be litigated in a Federal Court." (Emphasis added.)

In the case of *Venner v. Gt. Northern Ry.* (1908), 209 U. S. 24, 31-32, 28 S. Ct. 328, 52 L. Ed. 666, the Supreme Court held that there was diversity of citizenship to support federal jurisdiction in a case in which a citizen of New York, as plaintiff, brought an action against the corporation in which he was a stockholder and an individual defendant, both of whom were citizens of Minnesota. The action was instituted in a New York state court and was removed to the federal court on petition of the defendants. In considering the question of jurisdiction the court said:

"First, was there a controversy between citizens of different states? * * * Let it be assumed for the purposes of this decision that the court may disregard the arrangement of parties made by the pleader, and align them upon the side where their interest in and *attitude to the controversy* really place them, and then may determine the jurisdictional question in view of this alignment. Removal Cases, 100 U. S. 457, * * * If this rule should be ap-

plied it would leave the parties here where the pleader has arranged them. It would doubtless be for the financial interests of the defendant railroad that the plaintiff should prevail. But that is not enough. Both defendants unite, as sufficiently appears by the petition and other proceedings, in resisting the plaintiff's claim of illegality and fraud. They are alleged to have engaged in the same illegal and fraudulent conduct, and the injury is alleged to have been accomplished by their joint action. The plaintiff's controversy is with both, and both are rightfully and necessarily made defendants, and neither can, for jurisdictional purposes, be regarded otherwise than as a defendant. (Citations.) The case of *Doctor v. Harrington* is precisely in point on this branch of the case and is conclusive. * * *" (Emphasis added.)

The same rule was followed by the Supreme Court as recently as 1947 in the case of *Koster v. (American) Lumbermen's Mutual Cas. Co.* (1947), 330 U. S. 518, 67 S. Ct. 828, 91 L. Ed. 1067, and in 1954 by the Seventh Circuit in *Schmidt v. Esquire, Inc.* (7th Cir., 1954), 210 F. 2d 908. In the *Schmidt* case an Illinois stockholder-plaintiff brought an action in an Indiana state court against his own Delaware corporation and other Delaware corporations. The case was removed to the federal court on petition of the defendants other than the plaintiff's corporation. Plaintiff's motion to remand urged that plaintiff's corporation should be aligned as a party plaintiff for the purposes of testing diversity of citizenship and that there would then be a Delaware corporation on each side of the controversy and no federal jurisdiction. The court denied the motion to remand, saying:

"The plaintiff's motion to remand was based principally on the theory that, although Tucker Corpora-

> tion was named as a defendant in the complaint, for the purposes of testing diversity jurisdiction it should have been re-aligned as a plaintiff in accordance with its actual interest in the controversy. Thus, diversity would have been destroyed by the presence of a Delaware corporation on each side of the case. We note that in stockholder's derivative actions it has not been the practice to realign the corporation as a plaintiff, although the action is one to enforce a corporate claim and any recovery is for the benefit of the corporation. Koster v. (American) Lumbermens Mutual Cas. Co., 330 U. S. 518, 67 S. Ct. 828, 91 L. ed. 1067; Meyer v. Fleming, 327 U. S. 161, 66 S. Ct. 382, 90 L. ed. 595; Venner v. Gt. Northern Ry. Co., 209 U. S. 24, 28 S. Ct. 328, 52 L. ed. 666; Doctor v. Harrington, 196 U. S. 579, 25 S. Ct. 355, 49 L. ed. 606; Lavin v. Lavin, 2 Cir., 182 F. 2d 870, 18 A. L. R. 2d 1017. The corporation is left a defendant on the theory that it is controlled by antagonistic hands. * * * It does not seem that a different rule of alignment applies when, as in this case, there is no indication that the refusal by the corporate management to sue results from fraudulent or other improper motives. See Ashwander v. Tennessee Valley Authority, 297 U. S. 288, 56 S. Ct. 466, 80 L. ed. 688; * * *" (210 F. 2d 908, at 911.)

Thus the general rule as to the alignment of parties in stockholder's derivative actions seems to be, as stated in *Groel v. United Electric Co.* (*supra*) (C. C. N. J., 1904), 132 Fed. 252, 263:

> "The rule * * * is that, in a suit in equity instituted by a stockholder in his own name, but upon a right of action existing in his corporation, the stockholder's corporation will be aligned with the

defendants whenever the officers or persons controlling the corporation are shown to be opposed to the object sought by the complaining stockholder, * * *."

See also, in this connection, supporting this well-established rule:

Meyer v. Fleming (1946), 327 U. S. 161, 66 S. Ct. 382, 90 L. Ed. 595;

Cutting v. Woodward (9th Cir., 1918), 255 Fed. 633;

Annotation, 132 A. L. R. 193, at 197-202, and cases collected there;

Moore's Federal Practice (2nd Ed.), Secs. 23.21 and 19.03;

2 *Barron & Holtzoff,* Sec. 569, p. 177;

Opici v. Cucamonga Winery, et al. (S. D. Cal., 1947), 73 Fed. Supp. 603;

Dodge v. Woolsey, 18 How. 331, 15 L. Ed. 401;

New Jersey Central R. Co. v. Mills, etc. (1885), 113 U. S. 249, 5 S. Ct. 456, 28 L. Ed. 949;

Greenwood v. Freight (1882), 105 U. S. 13, 26 L. Ed. 961;

East Tennessee etc. R. Co. v. Grayson (1886), 119 U. S. 240, 7 S. Ct. 190, 30 L. Ed. 382.

(b) Alignment of Parties Where the Corporation's Management Opposes the Stockholder's Derivative Action.

In those cases, as in the case at bar, in which the management of the corporation has appeared and answered, or otherwise taken an adversary position in the actual litigation of a stockholder's derivative action, the corporation has been aligned as a party defendant for the purposes of jurisdiction.

An early case illustrating this principle is *New Jersey Central R. Co. v. Mills, etc.* (1885), 113 U. S. 249, 5 S. Ct. 456, 28 L. Ed. 949. In that case the plaintiff, a New Jersey citizen, brought an action in a New Jersey court against a New Jersey corporation in which he was a stockholder, and a Pennsylvania company. The case was removed to the federal court and all of the defendants filed a joint answer. The motion to remand, on the grounds that there was no diversity of citizenship since the plaintiff's corporation had to be aligned as a defendant, was granted. The Supreme Court affirmed the lower court saying:

> "All the defendants unite in defending the acts complained of, and in denying the illegality and fraud charged against them. *The New Jersey corporation is in no sense a* merely formal party to the suit, or a *party in the same interest with the plaintiffs, but is rightly and necessarily made a defendant.* * * *" (Emphasis added.)

The next year Mr. Chief Justice Waite decided a similar situation in *East Tennessee etc. R. Co. v. Grayson* (1886), 119 U. S. 240, 7 S. Ct. 190, 30 L. Ed. 382. This, again, was a case started in a state court, removed to the federal court, and then remanded; the issue was whether or not there was diversity of citizenship. In a situation closely parallel to the *New Jersey Central* case Mr. Chief Justice Waite said:

> "We are unable to distinguish this case from New Jersey Central R. v. Mills, 113 U. S. 249 * * *"

The stockholder's corporation, made defendant,

> "* * * is not a mere formal party, or a party in the same interest with Grayson, but is rightly and necessarily a defendant. The corporation, as a cor-

poration, has determined, by a vote of its stockholders, to pay $400,000, which it proposes to raise by a ruinous sale of stock, to get rid of a lease that Grayson insists is void and ought to be annulled without any payment whatsoever, * * * (H)ere the allegations of the bill, which, for the purposes of the present inquiry, must be considered as confessed, are to the effect that the two companies are acting in harmony upon the question of validity. * * * This is certainly the equivalent of the joint answer in the other case." (Refering to *New Jersey Central R. v. Mills.*)

In *Delaware & Hudson Co. v. Albany & Susquehanna R. Co.* (1909), 213 U. S. 435, 451, 29 S. Ct. 540, 53 L. Ed. 862, Mr. Justice McKenna reached a similar holding in a case in which the corporate defendant had demurred to the stockholder's bill.

This court has, in *Cutting v. Woodward* (9th Cir., 1918), 255 Fed. 633, 635, held in accordance with the above-quoted authorities. The facts there are reflected in the pertinent portion of the opinion, as follows:

"The trust company raises the question of jurisdiction, asserting that the company is not an adversary party to the plaintiffs in the suit, but is the real party in interest as plaintiff, and that consequently there is no diversity of citizenship. But this is not a case in which the trust company, although made a defendant, should be realigned as a plaintiff, as in *Hamer v. New York Railways,* 244 U. S. 266, 274, 61 L. ed. 1125. *Here the attitude of the trust company is hostile to the plaintiffs. It appeared in a joint answer with the appellant, and by the same counsel, and it denied the allegations of the bill and prayed for the dismissal thereof.* The cause is therefore one in which plaintiffs, citizens of Illinois, bring

> suit against defendants who are citizens of California. Doctor v. Harrington, 196 U. S. 579, 49 L. ed. 606; Venner v. Gt. Northern Railway, 209 U. S. 24, 52 L. ed. 666." (Emphasis added.)

The *Cutting v. Woodward* decision is particularly interesting and pertinent to instant appeal. There, as here, there was an Illinois citizen as party plaintiff; there, as here, the defendants were a California corporation and individual citizens of California; there, as here, it was urged that the plaintiff's corporation should be realigned as a plaintiff, which would defeat federal jurisdiction. There, as here, the attitude of the defendant corporation was hostile and actually opposed to the plaintiff, and it appeared, and denied the allegations of the bill, and prayed for the dismissal of the action. The differences between the two cases are, indeed, very slight. There the defendant corporation appeared by the same counsel as the individual defendants; in the case at bar the defendant corporation by a recent change *no longer* appears by the same counsel as the individual defendants *but it did at one time do so,* from the beginning of negotiations between plaintiff-appellant, in early December, 1952 [R. 12, 125, 135], until *after* this action was filed, namely, until May 4, 1953 [R. 142], five days after this action was filed. And clearly the present attorneys for all of the appellees recognize no adversary position between each other, for the attorneys who represented the defendant-appellee corporation until May 4, 1953, are still representing the individual defendants-appellees. As to pleadings, it is true that the individual and corporate appellees have not filed joint pleadings, but it is also true that they have filed motions on the same dates, asking for the same relief [R. 46 and 88, 254 and 257], and generally

"* * * are acting in harmony * * *" which is "* * * certainly the equivalent of the joint answer in the other case." (*East Tennessee R. Co. v. Grayson* (*supra*), 119 U. S. 240.)

This is also the rule of the California Supreme Court, *Wickersham v. Crittenden* (1895), 106 Cal. 329, 331, 39 Pac. 603.

See also:

Nagle v. Wyoga Gas & Oil Corp. (1935), 10 Fed. Supp. 905.

(c) Alignment of Parties in a Stockholder's Derivative Action Where the Corporation's Management Is Not Dominated by the Wrongdoers.

In making its findings of fact and conclusions of law the District Court found, *inter alia,* that the defendant corporation has not been under the domination of the individual defendants, or any of them, or under the control of any person or persons who have been antagonistic or hostile to the corporation at any time since at least as early as March 25, 1953.

A study of the decisions relative to the alignment of parties in that type of fact situation reveals that the courts again apply the rule of *Doctor v. Harrington,* 196 U. S. 579 (*supra*), and of *Groel v. United Electric Co.* (1904), 132 Fed. 252. As the Court of Appeals for the Seventh Circuit recently held, *Schmidt v. Esquire, Inc.* (1954), 210 F. 2d 908, 911:

> "It does not seem that a different rule of alignment applies when, as in this case, there is no indication that the refusal by the corporate management to sue results from fraudulent or other improper motives. See Ashwander v. Tennessee Valley Au-

thority, 297 U. S. 288, 56 S. Ct. 466, 80 L. ed. 688; Hill v. Wallace, 259 U. S. 44, 42 S. Ct. 453, 66 L. ed. 822; Delaware & Hud. Co. v. Albany & Susquehanna R. Co., 213 U. S. 435, 29 S. Ct. 540, 53 L. ed. 862; City of Chicago v. Mills, 204 U. S. 321, 27 S. Ct. 286, 51 L. ed. 504; Groel v. United Electric Co., C. C., 132 F. 252."

In the *Groel* case, *supra,* cited in *Schmidt v. Esquire, Inc.,* the management of the plaintiff's corporation did not receive the unlawful profits, it merely refused to bring the requested action to recover said profits (132 Fed. 252, 265.) The court held that this was sufficient to show that the plaintiff's corporation was in the control of officers who were carrying out the purposes of the other defendant company, and that their position in the controversy was one of

> "hostility to the position assumed by the plaintiff. The classification of the parties according to the facts places the New Jersey company * * * as a party defendant in the controversy."

A leading case in point is *Ashwander et al. v. Tennessee Valley Authority et al.* (1935), 297 U. S. 288, 56 S. Ct. 466, 80 L. Ed. 688, wherein Chief Justice Hughes reviewed the decisions saying, at page 319:

> "In such a case it is not necessary for stockholders —when their corporation refuses to take suitable measures for its protection—to show that the managing board or trustees have acted with fraudulent intent or under legal duress. To entitle the complainants to equitable relief, in the absence of an adequate legal remedy, it is enough for them to show the breach of trust or duty involved in the injurious and illegal action. Nor is it necessary to show that the transaction was *ultra vires* of the corporation.

The illegality may be found in the lack of lawful authority on the part of those with whom the corporation is attempting to deal. Thus, the breach of duty may consist in yielding, without appropriate resistance, to governmental demands which are without warrant of law or are in violation of constitutional restrictions. The right of stockholders to seek equitable relief has been recognized when the managing board or trustees of the corporation have refused to take legal measures to resist the collection of taxes or other exactions alleged to be unconstitutional (*Dodge v. Woolsey,* 18 How. 331, 339, 340, 345; *Pollock v. Farmers' Loan & Trust Co.,* 157 U. S. 429, 433, 553, 554; *Brushaber v. Union Pacific R. Co.,* 240 U. S. 1, 10); or because of the failure to assert the rights and franchises of the corporation against an unwarranted interference through legislative or administrative action (*Greenwood v. Freight Co.,* 105 U. S. 13, 15, 16; *Cotting v. Kansas City Stockyards Co.,* 183 U. S. 79, 113). The remedy has been accorded to stockholders of public service corporations with respect to rates alleged to be confiscatory (*Smyth v. Ames,* 169 U. S. 466, 469, 517; *Ex parte Young,* 209 U. S. 123, 129, 130, 143). The fact that the directors in the exercise of their judgment, either because they were disinclined to undertake a burdensome litigation or for other reasons which they regarded as substantial resolved to comply with the legislative or administrative demands, has not been deemed an adequate ground for denying to the stockholders an opportunity to contest the validity of the governmental requirements to which the directors were submitting. See *Dodge v. Woolsey, supra,* at pp. 340, 345; *Greenwood v. Freight Co.,* at p. 15; *Pollock v. Farmers' Loan & Trust Co., supra,* at pp. 433, 553, 554; *Brushaber v. Union Pacific R. Co., supra,* at p. 10.

In *Smith v. Kansas City Title Co.,* 255 U. S. 180, a shareholder of the Title Company sought to enjoin the directors from investing its funds in the bonds of Federal Land Banks and Joint Stock Land Banks upon the ground that the Act of Congress authorizing the creation of these banks and the issue of bonds was unconstitutional, and hence that the bonds were not legal securities in which the corporate funds could lawfully be invested. The proposed investment was not large,—only $10,000 in each of the classes of bonds described. *Id.,* pp. 195, 196. And it appeared that the directors of the Title Company maintained that the Federal Farm Loan Act was constitutional and that the bonds were 'valid and desirable investments.' *Id.,* p. 201. But neither the conceded fact as to the judgment of the directors nor the small amount to be invested,—shown by the averments of the complaint—availed to defeat the jurisdiction of the court to decide the question as to the validity of the Act and of the bonds which it authorized. The Court held that the validity of the Act was directly drawn in question and that the shareholder was entitled to maintain the suit. The Court said: 'The general allegations as to the interest of the shareholder, and his right to have an injunction to prevent the purchase of the alleged unconstitutional securities by misapplication of the funds of the corporation, give jurisdiction under the principles settled in *Pollock v. Farmers' Loan & Trust Co.* and *Brushaber v. Union Pacific R. Co., supra.*' *Id.,* pp. 201, 202. The Court then proceeded to examine the constitutional question and sustained the legislation under attack. A similar result was reached in *Brushaber v. Union Pacific R. Co., supra.* A close examination of these decisions leads inevitably to the conclusion that they should either be followed or be frankly overruled. We think that they should be

followed, and that the opportunity to resort to equity, in the absence of an adequate legal remedy, in order to prevent illegal transactions by those in control of corporate properties, should not be curtailed because of reluctance to decide constitutional questions." (297 U. S. 288, 319-321.)

And in *Delaware & Hudson Co. v. Albany & Susquehanna R. R. Co.* (1909), 213 U. S. 435, the court said:

"* * * The attitude of the directors need not be sinister. It may be sincere. * * * In this case it was certainly determined. It continued until after this suit was brought. * * *"

(2) Where the Action Is Collusive or There Is Want of Equity.

It is well settled that when the action is a collusive one, brought to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction the action will be dismissed.

"Where the arrangement of the parties is merely a contrivance between friends for the purpose of founding a jurisdiction which otherwise would not exist, the device cannot be allowed to succeed."

Dawson v. Columbia Ave. Trust Co. (1905), 197 U. S. 178, 181, 49 L. Ed. 713.

The same rule applies where there is want of equity.

Levitan v. Stout (D. C. Ky., 1951), 91 Fed. Supp. 105, 111.

That is not the situation in the case at bar [R. 3], and the court so found [R. 267].

C. The District Court Erred in Holding That the Corporation Has Not Been Under the Domination of the Individual Defendants, or Any of Them, or Under the Control of Any Person or Persons Who Have Been Antagonistic or Hostile to the Financial Interests of the Corporation Since at Least as Early as March 25, 1953.

This holding must be answered in a practical and realistic manner. Important facts to be considered are that the individual appellees constituted the entire board of directors until that date [R. 4], appellee Lordan is still a member of the board of directors of the corporation and is president of the corporation [R. 144], appellee Ferrar is still general business manager, secretary and treasurer of the corporation [R. 266], all of the individual appellees were members of the executive committee of the corporation at all times after October 10, 1950, and so far as the record shows they are still members of said executive committee; they comprise the entire executive committee [R. 5], and the individual defendants own 42.1% of the stock of the corporation and are all members and general partners of The Beverly Hills Clinic, which benefited financially from the transactions alleged at the expense of the corporation [R. 60-61]. In fact, the partners of The Clinic own 91% of the stock of the corporation [R. 61].

In addition, the new directors were selected for the corporation by the individual appellees at the suggestion of the attorney for the individual appellees [R. 135], shortly after he had learned that the plaintiff was about to file his action [R. 133]. Since the new directors were selected by the individual appellees it is significant to know the extent to which the new directors were acquainted with the individual appellees.

Robert Denny, a new director, knew appellees Lordan and Browne, was "only vaguely acquainted" with appellees Brandsma and Langley, and was "not acquainted at all" with appellee Dietrich [R. 54].

Robert Clark, a new director, was acquainted with appellee Lordan, "but has only a nodding acquaintance with" appellees Browne and Langley, and "has never met" appellees Dietrich or Brandsma [R. 51-52].

Homer Burnaby, a new director, does not mention his acquaintanceship with appellee Lordan but says that he is "only vaguely acquainted with" appellees Browne, Langley, and Dietrich, and had "never even met" appellee Brandsma [R. 49]. Clearly, some one at the meeting must have known Mr. Burnaby.

Shirley Burden, the other new director, "is well acquainted with" appellee Lordan, "but is only vaguely acquainted with" appellees Dietrich, Browne and Langley and "although at one time" he "was fairly well acquainted with Maynard Brandsma, he has not been in Mr. Brandsma's company for about ten years" [R. 183].

Actually, Mr. Burden is not here significant because there is no indication in the record that he participated in any of the actions of the board of directors until after his return from Europe in August, 1953 [R. 183].

The other remaining director is appellee Lordan.

Furthermore, all of the appellees, the corporation and the individuals, were represented by one and the same law firm from early December, 1952, until after this action was filed, and they were the persons with whom appellant's attorneys had to deal [R. 9, 12, 125, 135, 142]. It is inconceivable that in their capacity as attor-

neys for the appellee corporation they could have taken a position adversary to their position as attorneys for the individual appellees.

D. The District Court Erred in Holding That the Corporation Was Not at the Time of the Commencement of This Action and Is Not Now Incapacitated From Bringing or Maintaining Suit Upon the Causes of Action Set Forth in Plaintiff's Complaint Herein and From Protecting Its Own Financial Interests.

It is fundamental that a corporation can act only through its authorized agents, its board of directors and officers. Where the board of directors and officers refuse to act for the corporation then it is, as a practical matter, incapacitated from acting.

> *Groel v. United Electric Co.* (C. C. N. J., 1904), 132 Fed. 252, 262.

E. The District Court Erred in Holding That the Within Action Is Not One Between Citizens of Different States and That the Requisite Diversity of Citizenship Between the Plaintiff on the One Hand and the Defendants on the Other Did Not Exist at the Time of the Commencement or the Within Action and Does Not Now Exist and That It Did Not Then and Does Not Now Have Jurisdiction Over the Subject Matter.

When the appellee corporation remains properly aligned as a defendant, as was done in the complaint, and as it should have been on the basis of established law, as set forth above, there is complete diversity of citizenship with a citizen of Illinois as plaintiff and with citizens of California as defendants. This being true, and the other necessary jurisdictional facts being present as they are here, the court had jurisdiction over the subject matter.

F. The District Court Erred in Dismissing the Within Case for Lack of Jurisdiction Over the Subject Matter.

With all necessary jurisdictional facts present, as in paragraph "E" immediately above, it was error for the District Court to dismiss the action for lack of jurisdiction over the subject matter.

Respectfully submitted,

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